『社会科学ジャーナル』72〔2011〕
The Journal of Social Science 72[2011]
pp.*73-118*

Saving the Global Financial System: International Financial Reforms and United States Financial Reform, Will They Do the Job? – Part II –

Thomas J. Schoenbaum *

ARTICLE CONTENTS

* Research Professor of Law, George Washington University; Advisor to ICU-SSRI

IV. THE RESPONSE TO THE GLOBAL FINANCIAL CRISIS

1. The International Response

The Global Financial Crisis exposed the unpreparedness and inadequacy of international financial institutions. The IMF and the World Bank neither foresaw nor had the funds to ameliorate the Crisis. The dimensions of the Crisis were simply too vast and the political and financial limitations of international institutions were too great. National governments not international institutions took the lead in combating the Crisis. Nevertheless, international institutions played a key role in coordinating the national responses, and governments, seeing the impotence of international institutions, have taken significant steps to provide them with the means to be better prepared in the future.

(1) The G-20. The most important international body to deal with the Crisis was the G-20, a periodic meeting of the finance ministers and central bankers of the world's most important industrialized, emerging-market, and developing countries.[(1)] During the Crisis the G-20 has so far held four Summit meetings, in November 2008,[(2)] in April[(3)] and September 2009,[(4)] and in June 2010.[(5)] Perhaps more importantly, working groups of the G-20 met many times and were in constant touch during the Crisis. Although disagreements surfaced from time

(1) The nations represented are as follows: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, Republic of Korea, Turkey, United Kingdom, and United States. The 20th member is the European Union. The G-20 has largely supplanted the G-8, the meetings of the seven economically most important western countries plus Russia.

(2) Declaration of the G-20 Summit (Washington DC, November 2008). www.g20.org.

(3) G-20 Communique of the London Summit April 6-7, 2009. www.g20.org.

(4) Leaders' Statement: The G-20 Pittsburgh Summit, September 24-25, 2009. www.pittsburghsummit.gov.

(5) The G-20 Toronto Summit Declaration, June 26-27, 2010. www.g20.org.

to time, the real story of the G-20 is the remarkable concord, cooperation and coordination there has been over the past three years, probably the single biggest reason why the world has not plunged into a Great Depression similar to the 1930s.

The G-20 has successfully coordinated massive fiscal stimulus measures in member countries as well as monetary measures in most major economy countries that have reduced policy interest rates close to the zero interest floor. The G-20 has also opposed all forms of protectionism, adopting the wise course of pursuing global recovery. While many take this truth for granted today, its importance should not be underestimated. For an example of the dangers of allowing “beggar thy neighbor” policies to dominate, we have only to look at the example of what nations did during the last comparable economic crisis in the 1930s, which set the stage for World War II. This time the G-20 aims for “a fair and sustainable recovery for all.”(6)

The G-20 also took important decisions to make more money available to international financial institutions: (1) $750 billion for the IMF; (2) $350 billion in capital increases for the Multilateral Development Banks; and (3) $250 billion for trade finance. In addition, the G-20 decided to increase the voting power of developing and transition countries in the World Bank by 4.59%, giving them a total voting power of 47.19%. The G-20 also committed to move over time towards even more equitable World Bank voting power. The G-20 also endorsed reform of the IMF quota and voting system scheduled for completion at the end of 2011. These reforms will increase the voice of China, South Korea, Mexico, and Turkey and will revise many other countries’ quotas as well, giving developing and emerging-market countries more power at the IMF.(7)

The G-20 also has called upon members to adopt regulatory reforms: a new international regime for capital and liquidity standards for financial institutions,

---

(6) London Summit : Global plan for recovery and reform. www.londonsummit.gov.uk.

(7) IMF Survey: IMF Quota Reform. www.imf.org/external/pubs/ft. At the IMF each member has 250 basic votes plus one additional vote for each SDR 100,000 of quota. Quota reviews are held periodically, generally every five years.

more effective oversight and supervision of capital markets, measures to address systemic risks, and increased transparency.[8] The G-20 also approved the establishment of a Financial Stability Board to oversee the international financial system and mandated the Basel Committee on Banking Supervision to develop new and more stringent international capital and liquidity standards.[9]

The G-20 also addressed the sovereign debt crisis, committing to "making progress on rebalancing global demand" and affirming that "advanced countries [will] at least halve their deficits by 2013 and stabilize or reduce government debt-to-GDP ratios by 2016."[10]

The G-20 deserves immense credit for responsible action. Meetings of the G-20 are scheduled to continue on a twice-a-year basis. The next meeting is scheduled for Seoul in November, 2010.

(2) The International Monetary Fund. At the outset of the Crisis the IMF extended $50 billion in loans to 15 countries: the amounts were relatively small, ranging from $1.2 billion to Iceland to $16.7 billion to Ukraine. The Crisis exposed the weaknesses of the IMF,[11] in that these loans largely exhausted its available lending capacity. Now, largely because of the G-20 initiative described above,[12] the IMF enjoys reinvigoration and new respect. The ongoing reevaluation of quotas will change the power structure of the IMF, giving emerging-market and developing country members more say in the affairs of the organization. In 2009 the IMF instituted a new Flexible Credit Line lending program under which borrowers will be burdened with less conditionality.[13] This and other IMF lending programs will be greatly expanded as a result of $750

(8) The G-20 Toronto Summit Declaration, paras. 17-22 (June 26-27, 2010). www.g20.org.

(9) Ibid, at paras. 18-19.

(10) Ibid, at para. 10.

(11) See the statement by the Dominique Strauss-Kahn, Managing Director of the IMF, "Line of Liquidity to Confront Fear," *The Japan Times*, November 11, 2008, 8.

(12) The reevaluation is called the IMF Quota and Voice Reforms.

(13) Under many of its lending programs the IMF imposes strict conditions on borrowers. This has led to criticism that the IMF imposes austerity and economic misery as a condition of its loans.

billion of new capital, $500 billion coming from sales of bonds to the public and $250 billion coming from additional quota pledges from members. On July 19, 2010, the IMF announced that it would seek an additional $250 billion at the upcoming G-20 Summit in Seoul in November 2010.(14) "The IMF is back," said Managing Director Dominique Strauss-Kahn.(15) With its lending capacity now quadrupled, the IMF now once again plays a central role in providing liquidity to support the world economy.(16)

The U.S. Wall Street Reform and Consumer Protection Act, enacted on July 21, 2010, requires the U.S. Department of the Treasury to instruct the U.S. Executive Director of the IMF to provide special evaluation of any proposed loan by the Fund to a country whose debt exceeds its annual GNP, and to oppose such loan if the evaluation indicates that the loan is unlikely to be repaid in full.(17)

(3) The World Bank. Like the IMF, the World Bank has gone through an historic transformation as a result of the Global Financial Crisis. Members have agreed to support a $5.1 billion increase in the operating capital of the Bank and to give developing economies a greater voice in running the anti-poverty institution.(18) The Bank's lending is at a record's pace: $105 billion in financial commitments were concluded between July 2008 and April 2010, including a new Global Food Crisis Response Program for 21 African countries.(19) In its

(14) "IMF to Seek $250 Billion Boost in Its Lending Resources at G-20 Meeting," July 19, 2010, www.bloomberg.com/news, visited July 19, 2010.

(15) *Wall Street Journal*, April 3, 2009, 1. The IMF is also seeking the power to probe selected individual financial companies, large systemically important institutions, in the future in order to better carry out its job. The IMF famously failed to warn of the most severe economic meltdown since the 1930s. See Howard Schneider, "After Financial Crisis, IMF Seeks More Power over Individual Firms," *The Washington Post*, May 20, 2010, A15.

(16) The IMF played a crucial role in the creation of the European Financial Stability Fund, which was created by the EU and the ECB to support the euro.

(17) Public Law 111-203, section 1501.

(18) Sewell Chan, "World Bank Gives Poorer Countries a Bigger Role," *International Herald Tribune*, April 27, 2010, 1.

(19) www.worldbank.com/news, visited April 30, 2010.

lending the World Bank has focused on maintaining long-term infrastructure and sustaining private sector growth and job creation.[20] In addition to high lending volume, the Bank has changed the quotas of members: the US retains the highest share at 16%, but Japan is reduced to 6.84% while China will rise to 4.42%, a level above Germany, Britain and France. The quota shares (and voting power) of emerging and developing countries will rise by 3.13%, a cumulative shift of 4.59%, the greatest realignment of the Bank since 1988.[21]

(4) World Trade Organization. As a result of the Global Financial Crisis, world trade slumped about 9% in 2009, the first decline since 1980. The G-20 has joined WTO Director General Pascal Lamy in calling for completion of the long stalled WTO trade negotiations known as the Doha Development Agenda.[22] The G-20 has also called for continuation of Aid for Trade,[23] an initiative of the to increase the export capacity of developing countries through technical assistance, building trade-related infrastructure, and addressing supply-side obstacles to trade.[24] The WTO Working Group on Debt, Trade and Finance has also discussed problems of increasing sources of trade finance during the Global Financial Crisis.[25]

During the Crisis Pascal Lamy warned against trade protectionism, and the G-20 at the Washington Summit in November 2008 pledged that "we will refrain from raising new barriers in investment or to trade in goods and services,

(20) In addition, the President of the World Bank, Robert B. Zoellick, has called for each developed country to pledge 0.7% of its stimulus package to a "vulnerability fund" to assist developing countries that cannot afford bailouts and deficit spending. Robert B. Zoellick, "A Stimulus Package for the World," *International Herald Tribune*, January 24, 2009, 14. This proposal was not granted by the G-20.

(21) Ibid. This realignment is on top of a change in 2008 that approved a smaller shift of 1.46% shift in the voting power to developing countries and added a 25th member to the Governing Board, increasing to three the number of seats for sub-Saharan Africa.

(22) The Toronto G-20 Summit Declaration, op.cit.

(23) Ibid.

(24) See *Aid for Trade: Is It Working?* (OECD-WTO 2010), available at www.oecd.org/dataoecd.

(25) See www.wto.org/English/news, visited July 19, 2010.

imposing export restrictions or implementing World Trade Organization-inconsistent measures to stimulate exports." By and large this pledge was honored; however, a World Bank Report in March 2009[26] revealed that 17 of the G-20 nations have enacted 47 protectionist measures raising import duties or enacting trade-distorting subsidies in connection with economic stimulus measures during the Crisis.

(5) Bank of International Settlements (BIS) and the Basel Committee on Banking Supervision. The Bank of International Settlements is an international organization of the principal central banks of the world based in Basel, Switzerland. BIS provides the Basel Committee on Banking Supervision (BCBS) with its secretariat. The BCBS develops and recommends to BIS members standards designed to safeguard banks and financial institutions.[27] BCBS has power only to recommend such standards, but since the largest and most influential banks are global and can organize themselves to avoid stringent jurisdictions in favor of more lenient ones, global minimum standards are necessary to adequately safeguard the system. The BCBS recommends a three pillar approach to bank safety, emphasizing (1) minimum capital and liquidity requirements; (2) supervisory review; and (3) market discipline, disclosure requirements that allow market participants to judge risk. There have been two BCBS recommendations, known as Basel I (1988) and Basel II (2004).[28] Given the onset of the Global Financial Crisis only a short time after the promulgation of Basel II, the Basel Accords, although a glowing example of international cooperation, failed miserably. An effort is underway to revive Basel and to

---

(26) Richard Newfarmer and Elisa Gamberoni, *Trade Protectionism: Incipient But Worrisome Trends* (World Bank: March 23, 2009), available at www.voxeu.org/index, visited April 2, 2009.

(27) For a complete analysis, see Daniel K. Tarullo, *Banking on Basel: The Future of International Financial Regulation* (Peterson Institute for International Economics, 2008).

(28) For analysis of these accords, see Bryan J. Balin, *Basel I, Basel II, and Emerging Markets: A Nontechnical Analysis* (Washington D.C.: The Johns Hopkins University School of Advanced International Studies, 2008).

agree on a new Accord, Basel III that will set global rules for banks. Basel III is expected to be finalized by the end of 2010 and implemented by governments by the end of 2013. The ultimate result of the Basel Accord negotiations is expected to be highly influenced by US standards adopted by the Obama administration.[(29)]

Especially important will be the new Basel capital and liquidity standards and their implementation. A key cause of the Global Financial Crisis was that financial institutions took on too much leverage. Both the United States and the EU have conducted "stress tests" on major financial institutions that resulted in higher mandatory standards.[(30)] Now international negotiators must come to at least general agreement on tougher new standards.[(31)]

(6) Financial Stability Board (FSB). In 1999 the G-7 organized the Financial Stability Forum, a committee based in Basel to improve the functioning of the global financial markets. The FSF is based at the BIS and functions through a small secretariat. The FSF, however, failed to foresee and warn of the Global Financial Crisis, although in 2008 the FSF tabled recommendations to deal with the Crisis.[(32)] At the 2009 London G-20 -20 Summit it was agreed to broaden the FSF to include all G-20 members and to give the Forum a new name: the Financial Stability Board.[(33)] This new internationally entity is now just being organized; hopefully it will be allowed to play an effective future role.

International harmonization of financial standards is necessary because

(29) Andrew Ross Sorkin, "Bank Rules Need United Global Front", *International Herald Tribune*, January 27, 2010, 15.

(30) The U.S. bank stress tests in 2009 compelled 10 of the nation's biggest banks to raise a combined new capital cushion of $74.6 million. The EU stress tests in 2010 compelled 7 out of 91 banks to raise additional capital. For the results of the EU stress tests conducted by the Committee of European Banking Supervision and announced in July 2010, see www.c-ebs.org/Euwidestresstesting, visited July 31, 2010.

(31) For a report on the status of the negotiations, see David Enrich and Damian Paletta, "Pact Near to Require Banks to Hold More Capital," *The Washington Post*, June 4, 2010, A1.

(32) *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (Basel: April 12, 2008), available at www.financialstabilityboard.org/publication.

(33) London G-20 Summit Declaration, 2009.

financial institutions operate across national boundaries. Some national differences have emerged. For example, Germany has announced a total ban on the trading of "naked" short selling (a trader selling shares he does not own); this ban applies as well to most CDS trading.[34] International differences also exist on whether to tax bank transactions.[35]

(7) Proposals not accepted: calls for a supranational world reserve currency and a bank transaction tax. Several important proposals were put forth but not accepted by the G-20. First, China, joined by several additional nations, in March 2009, proposed the creation of a new, "super-sovereign" world reserve currency[36] by upgrading the Special Drawing Right (SDR), the monetary unit employed by the IMF. The Governor of the Bank of China, Zhou Xiaochuan, said this was necessary to correct "flaws" in the present international system. The widespread use of a more sovereign-neutral reserve currency would make it more difficult for the United States to run chronic current account deficits because surplus nations would have less incentive to purchase and hold dollar debt in their central banks. American economic influence would also be much diminished if the dollar were demoted as a reserve currency. Not surprisingly, China's proposal was rejected by the United States and many G-20 nations. At present the dollar continues to reign as the world's most important reserve currency[37]; the euro is second and the pound sterling and Japanese yen are distant also-rans. China, however, is taking the first small steps necessary to make the yuan a world reserve currency of the future: China offers yuan loans to foreign countries and accepts payment for some exports in yuan.

---

(34) Howard Schneider, "U.S., Germany Divided on Regulation," *The Washington Post*, May 5, 2010, A20.

(35) Ibid.

(36) The economist John Maynard Keynes proposed to create a sovereign-neutral reserve currency he called the Bankcor at the Bretton Woods Conference in 1944.

(37) The primacy of the dollar is not accepted by all. See Barry Eichengreen, "The Dollar Dilemma: The World's Top Currency Faces Competition", *Foreign Affairs* 88(5) (2009): 53-68.

A second international initiative not accepted by the G-20 is a proposal to tax banks or banking transactions. There are many varieties of bank taxes,[38] each has a specific purpose, and nations have been unable to agree on a specific proposal. The IMF is studying the various forms such a tax may take,[39] and some variety of bank tax may be proposed in the future.

(8) Some conclusions. The international community deserves high marks for the coordinated approach to the Crisis. International economic institutions are being reformed in meaningful ways in reaction to the Crisis, and political differences between key nations are being faced and honest compromises have occurred. The international response, particularly by the G-20, has been quite remarkable.

2. National Responses to the Crisis

National governments all over the world constituted the front-line response to the Global Financial Crisis. Unprecedented fiscal and monetary measures were passed by major developed nations who coordinated their policies through the G-20. Although some disagreement was evident, particularly with respect to the magnitude of the appropriate fiscal responses, nations acted largely in consultation and in solidarity with each other to mitigate the Crisis. This summary will concentrate on the actions of the United States, the world's largest economy and the origin of the Crisis.

1) Fiscal Measures

The primary fiscal weapon employed by the United States and many other developed nations was what was called "the bailout": massive injections of capital into financial institutions and in some cases "national champion" industrial companies. While bailout measures remain controversial politically, economically they appear to be necessary. A 2008 study by two IMF

(38) The most famous such proposal is the Tobin tax proposed in the 1970s by Nobel laureate James Tobin which would be a tax on foreign exchange transactions.

(39) See www.imf.org/policy, visited July 22, 2010.

economists[40] of 47 financial crises spanning 37 countries, none as severe as the present Crisis, concluded that tactical responses to financial crises usually did not work and even exacerbated the overall bill from the crisis. In most cases a comprehensive solution is required and the sooner it is applied the better. For example, Japan's tepid and piecemeal response[41] to the Japanese financial crisis of 1990-91 resulted in a "lost decade" of economic stagnation. The global fiscal response to the present Crisis was mixed, ranging from China, which adopted a stimulus of approximately 15% of GDP, to Germany, which approved a stimulus equal to only 1.6% of GDP. The U.S. stimulus was $787 billion, about 3.5% of GDP.

(1) The US TARP[42] (Troubled Asset Relief Program). The US TARP program passed by Congress at the height of the Crisis in October 2008 authorized the US Department of the Treasury to spend up to $700 billion to purchase "troubled assets" vaguely defined as securities whose purchase was deemed necessary to promote financial market stability. The Dodd-Frank Wall Street Reform and Consumer Protection Act, Title XII reduced the total TARP authorization to $475 billion.[43] The TARP actually involves several quite different programs[44]:

- Capital Purchase Program (CPP). Under this, the largest TARP program,

---

(40) Luc Laeven and Fabian Valencia, "Systemic Banking Crises: A New Database," *IMF Working Paper*, September 2008.

(41) See Satoshi Shimizutani and Heather Montgomery, "Bank Recapitalization in the West: Lessons from Japan," *Nihon Keizai Shimbun*, November 27, 2008, 3. The authors point to three "lessons": First, the timing and scale of the Japanese government's bank recapitalizations were faulty – too little too late. Second, Japan failed to set clear policy goals for the program. Third, Japan failed to coordinate bank recapitalization with other fiscal and monetary policies.

(42) The Emergency Economic Stabilization Act of 2008, Public Law No. 110-343.

(43) Public Law No. 111-203, section 1302.

(44) Current information on TARP is available at www.financialstability.gov. Especially helpful are the monthly TARP 105 (a) Reports to Congress. The following information is taken from Troubled Assets Relief Program (TARP), Monthly 105 (a) Report – July 2010 (US Department of the Treasury, August 10, 2010), available at www.financialstability.gov/docs/105, visited August 25, 2010.

$204.89 billion was disbursed to purchase senior preferred stock and warrants in commercial banks and thrift institutions. Of this amount $146.88 billion has been repaid as of this writing.

- Targeted Investment Program (TIP). $40 billion was employed to purchase shares in Citibank and Bank of America. This $40 billion has been repaid in full.
- Asset Guarantee Program. Although $5 billion was allocated for this program, no money was disbursed and this program is now closed.
- American International Group, Inc. (AIG). The current allocation to AIG is $69.8. This amount is on top of the special credit facility created by the US Federal Reserve on September 16, 2008, to enable AIG to meet increased collateral obligations consequent to its credit rating downgrade. AIG has benefitted from government largesse amounting to a total of $182.5 billion. None of this funding has been repaid.
- Term Asset-Backed Securities Loan Facility (TALF). Originally $20 billion was allocated under TARP to the Federal Reserve Bank of New York to restart the securitization markets by using TALF to provide non-recourse term loans collateralized by triple A rated asset-backed and commercial mortgage-backed securities. However, only $4.3 billion was disbursed, and this program is now closed.
- Securities Purchase Program. $400 million is currently allocated to help revive the small business lending market.
- Small Business Lending Fund. No money was ever spent and this program is now closed. The Congress may pass special legislation to help small business lending.
- Community Development Capital Initiative. This program, which was for the purpose of aiding small, community-based financial institutions, is now reduced to $800 million.
- Auto Industry Financing Program. $81.8 billion is allocated to provide both equity and loans to General Motors and Chrysler Corporations as well as Ally Financial (GMAC). Of this amount, 11.2 billion has been repaid. The

subsidies extended to industrial companies by the US and many foreign governments may violate the rules of the World Trade Organization (WTO). The WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement)[45] specifies in Articles 5 and 6.3 that government aids that constitute "actionable" subsidies may either be challenged directly using the WTO dispute settlement mechanism or imports from the subsidized companies may be subject to countervailing duties. A subsidy is "actionable" under the SCM Agreement if it is shown to (1) impede exports of "like" products (a "serious prejudice" finding) and (2) cause material injury to a domestic injury. However, at this writing, no member of the WTO has challenged any of the subsidies enacted during the Global Financial Crisis.

- Public Private Investment Program (PPIP). This program was announced on March 29, 2009 as a Financial Stability Plan to purchase up to $1 trillion in "toxic" mortgage-backed and asset-backed securities. The purpose of PPIP is to support market functioning and to facilitate price discovery in the securitization markets, allowing banks and financial institutions to re-deploy capital and to extend new credit to households and businesses. Eight investment funds approved by the US Department of the Treasury have invested $7.4 billion in PPIP. The TARP has matched the equity contribution of the private funds and has contributed additional non-recourse loans so that the total TARP expenditure for PPIP is $22.4 billion. The average gain posted by the eight funds is 15.5%, and US Treasury has recouped $370 million from this program. An additional paper profit of $657 million (more or less) may be realized at some future time.[46] Although the PPIP has achieved modest success, it has not lived up to its announced purposes. An estimated $1.8 trillion worth of distressed

(45) The WTO SCM Agreement may be found at www.wto.org/documents.

(46) United States Department of the Treasury, *Legacy Securities Public-Private Investment Program, Program Update – Quarter Ended June 30, 2010* (July 19, 2010), available at www.financialstability.gov/doc.

residential and commercial mortgage-related securities that were eligible for purchase when the program began still remain on the books of financial institutions.(47)

- Home Affordable Modification Program (HAMP). $45.6 billion is allocated to fund housing programs and initiatives that address the housing crisis. The centerpiece of the housing programs is HAMP, which provides subsidies to lenders in connection with loan modifications. The results of HAMP so far have been disappointing: only 340,000 homeowners out of an estimated 4 million eligible for assistance have seen their mortgages permanently modified.(48) HAMP will end December 31, 2012.

The US Department of the Treasury is now winding down the TARP. So far $194 billion in TARP funds have been recouped or repaid, and the total cost of TARP is projected to be $105.4 billion. The Department of the Treasury expects this cost figure to further decrease as the government collects interest or sells its interests. Title XIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, denominated the Pay it Back Act, proposed to create a $19 billion fund composed of assessments on financial companies with $50 billion or more of assets in order to pay the administrative costs of the TARP. At the last minute, however, this fund was dropped from the Act because of the objections of Senator Scott Brown (R. Mass.).

(2) The Housing and Economic Recovery Act of 2008.(50) The Housing and Recovery Act created the Federal Housing Finance Agency (FHFA) in 2008, which on September 7, 2008 announced "conservatorship" of the two US mortgage guarantee agencies, Fannie Mae and Freddie Mac. In December 2009

(47) Eric Dash, "US taxpayers earning return on bailout," *International Herald Tribune*, August 28, 2010, 16.

(48) See Office of the Special Inspector General for the TARP, *Report to Congress*, July 22, 2010, 6, available at www.sigtarp.gov/reports/Congress/2010/July, visited July 23, 2010.

(49) www.financialstability.gov/news, visited July 21, 2010.

(50) Public Law 110-89, 122 Stat. 2654 (July 30, 2008).

FHFA announced that it was removing the cap on US Treasury support of both agencies so that they presently have access to unlimited government funds. Fannie and Freddie at this writing are providing financing for more than 90% of the US mortgage market, following the collapse of the market for bonds backed by private sector mortgages. Fannie and Freddie fund their activities in two ways: by selling their own debt and by buying mortgages and packaging them into securities for sale to investors. The US government so far has injected over $110 billion into Fannie and Freddie, and the longer term status of both companies remains to be addressed. Three options are possible for the future: total privatization; total nationalization; and reestablishing them as shareholder-owned but government-sponsored companies.

(3) The American Recovery and Reinvestment Act of 2009.(51) Like most developed nations the United States enacted a major economic stimulus program in response to the Crisis. The ARRA authorizes stimulus spending of up to $787 billion for a variety of projects. Some economists(52) criticize the US stimulus program as too timid and call for additional government programs focused on job creation. Many governments have enacted larger stimulus programs as a proportion of GDP. For example, China responded to the Crisis by authorizing a stimulus of 4 trillion renminbi (about $585 billion). The European Union, in contrast, has chosen to pass measures that emphasize social welfare spending and has passed limited stimulus spending, averaging about 3.5% of GDP.

(51) Public Law 111-5, 123 Stat. 115 (2009). This law contains a combination of tax cuts for individuals and businesses and spending for transportation (highways – the biggest single item), education, health, water and sewage, housing, government buildings and facilities, energy infrastructure and research, scientific research, state and local government needs, and the public lands.

(52) E.g., Paul Krugman, “That 30s Feeling,” *The Washington Post*, June 20, 2010, A16; and “The Third Depression,” *The Washington Post*, June 29, 2010, A18.

(4) The US Car Allowance Rebate System (cash for clunkers).[53] From June to August 2009 the United States offered rebates of cash to car buyers who traded in certain older models for new cars. The purpose of this program was to stimulate consumer demand. Toyota and General Motors were the chief beneficiaries of this program, which cost a total of $3 billion.

2) Monetary Policy

The central banks of most developed nations have cut key interest rates to near zero to combat the Global Economic Crisis. In addition, key central banks, such as the US Federal Reserve, the ECB, the Bank of Japan, and the Bank of England, have engaged in "quantitative easing", expanding the money supply by purchasing government and corporate bonds. Central banks have also engaged in "qualitative easing" by direct purchases of risky and illiquid "toxic" assets, such as MBSs and ABSs.[54] Quantitative and qualitative easing not only increase the money supply but also tend to drive down long term interest rates, which can complement lowering key central bank rates, which tends to drive down short-term interest rates. Never before has quantitative and qualitative easing been used by central banks on such a massive and coordinated scale as during this Crisis.[55] At this writing the US Federal Funds rate is 0.25%; the key rate at the Bank of Japan is 0.1%; the ECBs key rate is 1%; and the Bank of England's key rate is 0.5%. On June 28, 2010, the Bank of International Settlements (BIS)

---

(53) Title XIII of the Supplemental Appropriation Act of 2009, Public Law 111-32.

(54) In the United States a key program is the TALF (Term Asset-backed Securities Loan Facility) operated by the Federal Reserve under the authority of section 13(3) of the US Federal Reserve Act. Under this program the Federal Reserve Bank of New York (FRBNY) extends loans of up to 5 years to holders of eligible asset-backed securities. The loans are non-recourse, meaning that the borrower can be discharged upon surrender of the security as collateral to the FRBNY. See www.federalreserve.gov/releases/h41/Current, visited July 21, 2010.

(55) On July 15, 2010 the balance sheet of the US Federal Reserve, which is a broad gauge of the Fed's support of the financial system, stood at a near-record $2.324 trillion. www.federalreserve.gov/newsevents/press/monetary, visited July 21, 2010.

formally called on key central banks to begin raising rates. The BIS report stated that policy makers must begin raising official interest rates to avert inflation and to wean banks from their dependency on the massive amounts of cash central banks have provided.(56)

The U.S. Federal Reserve also took the extraordinary step of making loans to four industry facilities and even to private companies in financial trouble, such as Bear Stearns and AIG, under the authority of section 13(3) of the Federal Reserve Act.(57) As a result, the balance sheet of the Fed stands at $2.308 trillion, the highest in history. The Fed also now pays interest on reserve balances of depository institutions.(58)

Some conclusions. Although the Bernanke-led US Federal Reserve failed to foresee the Crisis, the Fed deserves praise for adopting necessary monetary policies and employing unorthodox methods such as emergency lending under section 13(3) of the Federal Reserve Act and quantitative easing. The real test for the Fed will be when to decide to end its easy money policies in order to avoid inflating the money supply to such a degree so as to spur an inflationary cycle that will be hard to stop once it takes hold.(59) There is also an important downside to the Fed's radical easy money policy: low interest rate policies mean that investments and savings do not generate income.(60)

---

(56) Jack Ewing, "Bank Group Warns Time Has Come to End Aid," *International Herald Tribune*, June 29, 2010, 1.

(57) See Mark S. Nelson, "The Other Bailout: How the Fed Is Financing the Financiers, and Related SEC Disclosure," *Wolters Kluwer Law and Business* (CCH, 2008).

(58) Testimony, Chairman Ben S. Bernanke, *Semiannual Monetary Policy Report to Congress*, July 21, 2010. www.federalreserve.gov/newevents/testimony/bernanke, visited July 24, 2010.

(59) One idea would be for the Fed to announce publicly that interest rates will be kept within a certain range until inflation reaches a specified level, say 2%.

(60) The current Fed zero interest rate policy also constitutes a subsidy to banks and financial institutions by widening the spread between what they charge in terms of interest (consumer credit card interests rates remain high despite the Fed's policy) and what they must pay to savers and investors.

US fiscal policy deserves a much lower grade. The TARP prevented the collapse of the nation's commercial banks and auto companies, but just barely. The TARP money has failed to alleviate the credit crunch because the US Treasury was leery of exercising any control over bank management policies, fearing the political charges of "government takeover," "nationalization" and "socialism." Treasury simply gave the banks money in return for non-voting preferred stock, no strings attached. Not only did banks not resume lending, 17 financial companies that received TARP funds in 2008 immediately handed out $1.58 billion in bonuses to senior employees.(61) Many of the TARP's multi-billion dollar programs have disappointed. The stimulus bill passed by the Congress was also flawed, resembling more a "pork barrel" measure with no measure of coherence: the single largest expenditure was for highway construction.(62)

V. U.S. REGULATORY REFORM

On July 21, 2010 the historic US Dodd-Frank Wall Street Reform and Consumer Protection Act became law, the most ambitious overhaul of the legal framework governing the US financial system since the 1930s. Dodd-Frank is a valiant attempt to deal point-by-point with the perceived causes of the financial meltdown that began in 2007. This new law, some 2319 pages long, passed

---

(61) See Kenneth R. Feinberg, *Report by the Special Master for Executive Compensation*, July 23, 2010, available at www.UStreas.gov/reports, visited July 24, 2010. See also Eric Dash, "Federal Report Faults Banks on Huge Bonuses," *New York Times*, July 23, 2010, A1. According to the Feinberg Report, 80% of the pay was unmerited. However, the payments were not illegal because they were made before legal limits were placed on the payment of bonuses by financial companies receiving bailout money in 2008.

(62) As Alan Blinder, Princeton economist, put it, "The branding and marketing was done very poorly. When you spend that much money, there should be more recognition." Quoted in "Democrats Get Little Boost from Stimulus," *The Washington Post*, August 2, 2010, 1A. Another economist, Robert Shapiro, chairman of Sonocon, stated that "We used stimulus to stop a slide toward depression, and it was successful in doing that. But it wasn't enough to create strong growth." Quoted in "Job Losses Fueling Recovery Concerns," *The Washington Post*, August 2, 2010, 1A.

narrowly and is still highly controversial. Although a definitive evaluation is premature, since many provisions depend on the enactment of implementing regulations by government agencies,[63] a process that will take some years, I offer an outline and preliminary assessment of the principal sections of the law. Studies of past financial crises, none as serious as the present Crisis, have concluded that regulatory forbearance is a common failing[64] in such crises, but the paramount issue is how the new regulatory structure responds to the failings that caused the present Crisis.

1. The Financial Stability Oversight Council: The Advance Warning System

A centerpiece of the new law[65] is the establishment of a new Financial Stability Oversight Council (hereinafter the Council)[66] composed of nine voting members, the Secretary of the Treasury (the Chair of the Council), the Chairman of the Federal Reserve, the Comptroller of the Currency, the Director of the newly-established Bureau of Consumer Financial Protection, the head of the Securities Exchange Commission, the head of the Commodity Futures Trading Commission, the Director of the Federal Housing Finance Agency, and an independent member appointed by the President with the advice and consent of the Senate who has insurance expertise.[67] The Director of the Office of Financial Research sits on the Council as a non-voting member.[68] This Council meets at the call of the Chair but not less than quarterly, and operates

(63) The new law requires agencies to pass 350 rules, conduct 47 studies and issue 74 reports according to the count of the U.S Chamber of Commerce. See www.uschamber.com/financialregulation, visited June 23, 2010.

(64) Luc Laeven and Fabian Valencia, *Systemic Banking Crises: A New Database*, IMF Working Paper, September 2008, available at www.imf.org/reports, visited July 22, 2010.

(65) Title I of the Regulatory Reform Act is named the "Financial Stability Act of 2010." Section 101.

(66) Section 111(a).

(67) Section 111(b)(1).

(68) Section 111(b)(2).

by majority vote.[69] The purpose of this Council is threefold: (1) to provide early warning of risks to the financial system; (2) to promote market discipline; and (3) to respond quickly to threats to the stability of the financial system.[70] The Council has vast powers to collect information not only from federal and state agencies but also from all financial institutions whether bank holding companies or non-bank financial companies as well as foreign financial companies that do substantial business in the United States.[71] The Council also has authority to resolve jurisdictional disputes among federal financial agencies.[72] The intent of the law is to give the Council clear oversight authority over federal financial agencies and all financial companies doing business in the United States without exception.

The Council has authority to take several specific actions to safeguard the US financial system. First, the Council may determine by two-thirds vote that a situation of "material financial distress" exists at US or a foreign non-bank financial company and that the company should be supervised by the Federal Reserve and be subject to enhanced prudential standards.[73] Such non-bank financial companies are then required to register with the Federal Reserve within 180 days of the Council's determination.[74]

Second, the Council may make recommendations to the Federal Reserve to establish and apply to certain financial companies that are determined to be in material financial distress prudential standards that are "more stringent than those applicable to other" financial companies.[75] These prudential standards may cover such matters as risk-based capital requirements, leverage limits, liquidity requirements, concentration limits, contingent capital requirements,

---

(69) Section 111(e) and (f). Exceptionally a two-thirds vote is required for certain actions.
(70) Section 112(a).
(71) Section 112(a)(2).
(72) Section 119.
(73) Section 113.
(74) Section 114.
(75) Section 115.

enhanced public disclosure, overall risk management requirements and a resolution plan and credit exposure report requirements.(76) The Council may make recommendations to the Federal Reserve to require that each such financial company report periodically the plan of such company for "rapid and orderly resolution of such company in the event of material financial distress or failure."(77) This provision is termed the requirement that certain financial companies have "living wills."

Third, the Council may issue recommendations to the primary financial regulatory agencies to apply enhanced regulatory standards with respect to any financial activity or practice determined by the Council to "create or increase the risk of significant liquidity, credit, or other problems" spreading among financial institutions or the financial markets of the United States.(78) Such recommendations must be implemented by the agencies within 90 days or the agency must explain in writing why it has determined not to follow the recommendation.(79)

Fourth, the Council may by two-thirds vote require that a bank holding company with total consolidated assets of $50 billion or more or a non-bank financial company supervised by the Federal Reserve terminate certain specific activities, impose conditions on certain activities, or transfer certain activities to unaffiliated entities.(80)

Because most of the Council's work will be implemented through the Federal Reserve, the Board of Governors of the Federal Reserve System is granted enhanced authority over non-bank financial companies as well as bank holding companies with respect to requiring information and reports,(81)

---

(76) Section 115(b)(1).
(77) Section 115(d).
(78) Section 120.
(79) Section 120(c).
(80) Section 121.
(81) Section 161.

enforcement,[82] approval of mergers and acquisitions,[83] and prohibition of management interlocks.[84] The Federal Reserve is also authorized to develop and require enhanced prudential standards for all financial companies, including requiring that each company report periodically its resolution plan for rapid and orderly resolution in the event of material distress or failure.[85] The Federal Reserve may also prescribe regulations concerning early remediation of financial companies in order to impose corrections to prevent failure.[86]

Section 117 of the Act was dubbed the "Hotel California" provision in reference to the hit song of this name by the Eagles in 1977 (the Hotel California is a hotel from which "you can check out any time but you can never leave"[87]). This section provides that bank holding companies that received TARP bailout money cannot evade the authority of the Federal Reserve by ceasing to be bank holding companies at some future time. In an oblique reference to Lehman Brothers and other investment bank shenanigans, section 165 of the Act states that in formulating enhanced prudential standards, the Federal Reserve may consider "off-balance-sheet activities" of companies under its supervision.[88]

An Office of National Insurance is created by the Act within the US Department of the Treasury in order to monitor the insurance industry and to identify gaps in the regulation of insurance that could cause systemic risks to the US financial system.[89] This Office has the power to recommend to the Financial Stability Oversight Council that it designate particular insurers as entities subject to regulation as a non-bank financial company supervised by the Federal Reserve.[90] This Office will also serve as a national voice on insurance matters in

(82) Section 162.
(83) Section 163.
(84) Section 164.
(85) Section 165.
(86) Section 166.
(87) This was intended apparently to refer to the high life in Los Angeles.
(88) Section 165(k).
(89) Section 313.
(90) Section 313(c).

the international arena.

The Council is to be assisted in its determinations by a new Office of Financial Research established in the Department of the Treasury.(91) This new office has wide powers to monitor financial markets and companies and to conduct investigations and studies.(92) The successful operation of the new Council will depend heavily on the work of this new Office.

2. Orderly Liquidation Authority: Dealing with Insolvencies of Certain Financial Companies

Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act establishes a special bankruptcy process for financial companies, including banks and bank holding companies, non-bank financial companies, broker-dealers and insurance companies. Substantial new authority is granted to the Federal Deposit Insurance Corporation (FDIC) to act as receiver of financial companies designated for financial resolution or liquidation.

The orderly liquidation authority is triggered by a "systemic risk determination" which requires several steps. First, the appropriate federal agency, the FDIC in the case of an insured depository institution and the Board of Governors of the Federal Reserve in the case of other financial companies,(93) must by two-thirds vote make written recommendations and determinations that must include an evaluation whether the financial company is in default or in danger of default, a description of the effects default would have on the financial stability of the United States, a recommendation concerning the nature and extent of actions to be taken, an evaluation of the likelihood of a private sector alternative to prevent default, an evaluation why a case under the Bankruptcy Code is not appropriate, and an evaluation of the effects on creditors

(91) Section 152.

(92) Section 152(c).

(93) In the case of a broker-dealer company the SEC must also approve by a two-thirds vote. Section 203(a)(1)(B).

and other stakeholders of the company.[(94)]

The second step is up to the Secretary of the Treasury in consultation with the President, who may act upon the written recommendations of the FDIC or the Federal Reserve to determine that (1) the financial company is in default or danger of default[(95)]; (2) the failure of the company would have serious adverse effects on the financial stability of the United States; (3) no viable private sector alternative is available; (4) any impact on claims or interests of creditors, shareholders and other interested parties is appropriate given the impact action would have on the financial stability of the United States; (5) orderly resolution of the financial company would mitigate potential adverse effects on the financial system; and (6) the appropriate federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to the regulatory order.[(96)]

The third step authorizes the Secretary of the Treasury who makes the required findings to file a petition with the Orderly Liquidation Panel, a newly established three-judge panel of the United States Bankruptcy Court for the District of Delaware, for an order authorizing the appointment of the FDIC as receiver for the financial company in question.[(97)] The decision of the Panel may be appealed to the United States Court of Appeal for the Third Circuit with expedited review in the Supreme Court of the United States.[(98)]

The FDIC as receiver has broad powers to deal with all aspects of the resolution of the designated financial company.[(99)] The financial company in distress may be rehabilitated or liquidated in whole or in part.[(100)] The FDIC may organize a bridge company to take temporary control of certain assets

---

(94) Section 203(a)(2).

(95) Section 203(a)(4) of the Act defines these important terms.

(96) Section 203(b).

(97) Section 202(b)(1)(A).

(98) Section 202(b)(2).

(99) Section 204.

(100) Sections 210.

and liabilities of the financial company.(101) If the financial company is broker-dealer the SIPC must be appointed trustee to safeguard customer securities and property.(102) In the case of insurance companies that are covered financial companies, liquidation or rehabilitation must be conducted under the law of the state where it has its seat of operations.(103) To assist the resolution liquidation process the FDIC may draw on a newly created Orderly Liquidation Fund whose target amount is $50 billion.(104) The Fund will be capitalized over a period of not less than ten years by assessments on financial companies with total financial assets of at least $50 billion.(105)

3. Reform of the Federal Reserve System: no future bailouts (?)

Section 13(3)(A) of the Federal Reserve Act(106) authorizes emergency lending by the Federal Reserve in exigent circumstances. This authority was used by the Fed during the Financial Crisis for the first time since the Great Depression of the 1930s to provide liquidity and to prevent insolvency by lending to various companies and facilities,(107) such as AIG and Bear Stearns. Title XI of the Act curtails the Federal Reserve's power to make emergency loans: bailouts of individual companies are now prohibited.(108) The Fed may, however, lend to a facility for the purpose of providing liquidity to the financial system, but the security for such a loan must be "sufficient to protect taxpayers from losses" and such a program must be terminated in a "timely and orderly

(101) Section 210(a)(1)(F).
(102) Section 205.
(103) Section 203(e).
(104) Section 210(n).
(105) Section 210(o).
(106) 12 U.S.C. sec. 343.
(107) During the Financial Crisis the Fed made liquidity loans to four "facilities": the Commercial Paper Funding Facility, the Money Market Investor Funding Facility, the Primary Dealer Credit Facility, and the Term Securities Lending Facility. www.newyorkfed.org/markets/funding_archive/index, visited July 15, 2010.
(108) Section 1101(a)(6)(B)(i).

fashion."[109] The Fed's emergency lending must be publicly disclosed and is subject to audit by the Comptroller General of the United States.[110] The FDIC can guarantee debt of solvent insured banks only upon the approval of two-thirds of the Boards of the Fed and the FDIC that emergency financial stabilization is required, approval by the Secretary of the Treasury who must set a cap on the funding required, and subsequent approval by joint resolution of both the US Senate and the House of Representatives.[111]

4. Consolidation of Bank Regulators

Title III of the Dodd-Frank Wall Street Reform and Consumer Protection Act eliminates the US Office of Thrift Supervision and establishes clear lines of regulatory authority for the principal bank regulation agencies. The purpose of this reform is to eliminate "regulatory arbitrage," the practice of shopping around for the best regulatory deal. The Office of Thrift Supervision, whose savings institutions suffered multiple failings during the Crisis, is abolished and its functions and employees are transferred to other banking agencies.[112] With this consolidation the FDIC will have regulatory responsibility over state banks and state savings institutions of all sizes and bank holding companies of state banks with total assets less than $50 billion.[113] The Office of the Comptroller of the Currency will regulate national banks and federal thrifts of all sizes and holding companies of national banks and federal thrifts with assets below $50 billion.[114] No new charters may be issued for federal thrift institutions.[115] The Federal Reserve will regulate bank and thrift holding companies with assets over $50 billion.[116]

(109) Section 1101(a)(6)(B)(ii).
(110) Sections 1102-03.
(111) Sections 1104-05.
(112) Section 313.
(113) Section 312(b)(1)(C).
(114) Section 312(b)(1)(B).
(115) Section 341.
(116) Section 312(b)(1)(A).

The FDIC has greater authority through amendments to the Federal Deposit Insurance Act[117] that increase the assessment base upon which deposit insurance premiums are calculated[118] and increase the reserve ratio of the Deposit Insurance Fund to 1.35% of insured deposits. The Act also makes permanent the increase in standard maximum federal deposit and share insurance to $250,000.[119]

Section 342 of the Act mandates the establishment of an Office of Minorities and Women Inclusion in each of several federal banking agencies, including the Federal Reserve, the FDIC, the Comptroller of the Currency, the SEC, and the new Bureau of Consumer Financial Protection. The purpose of these offices is to promote "diversity in management, employment, and business activities."[120]

5. Banking Reforms

During the Financial Crisis many banks suffered losses through affiliate financial companies because after the repeal of the Glass-Steagall Act, banks in the United States were permitted to form or acquire investment banking affiliates. During the Crisis there were calls to reenact Glass-Steagall in some form,[121] to again place a line of separation between commercial banking and investment banking. However, the day was carried by a proposal made by Paul Volcker, former chairman of the U.S. Federal Reserve and the Chairman of President Barak Obama's Economic Recovery Advisory Board. Volcker proposed that commercial banks be permitted to continue some investment banking activities, such as underwriting securities and trading securities on behalf of clients, but that banks be prohibited from owning hedge and private

(117) 12 USC secs. 1812 et seq.

(118) Sections 334-35.

(119) Section 335.

(120) Section 342(a)(1).

(121) E.g., see Cyrus Senati, "Yearning for Glass-Steagall on Capitol Hill," *New York Times*, January 22, 2010, www.dealbook.blogs/nytimes/2010/01/22, visited March 20, 2010.

equity funds and be forbidden to engage in proprietary trading, buying and selling risky securities for their own account rather than in response to customer needs.[122]

(1) Volcker rule. Section 619 of Title VI of the Act codifies what is known as the "Volcker rule," which was the focus of lobbying activities of financial institutions in the weeks preceding the enactment of the new law.[123] As passed by Congress, the Volcker rule is but a shadow of Paul Volcker's original proposal. Under the Volcker rule banks (defined as any company that controls a depository institution) are prohibited from sponsoring or investing in a hedge fund or private equity fund[124] (funds that are exempt from registration under the Investment Company Act); and cannot engage in proprietary trading,[125] defined as "purchasing or selling, or otherwise acquiring and disposing of stocks, options, commodities, derivatives, or other financial instruments," but not including doing so on behalf of a customer.[126] However, the Act makes exceptions[127] for (1) investment in obligations or the US government; (2) financial instruments issued by Ginnie Mae, Fannie Mae, Freddie Mac, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a farm credit system institution; (3) obligations of a state or local government; (4) underwriting and market making activities not to exceed the near-term demands

---

(122) Paul Volcker, "How to Reform Our Financial System," *International Herald Tribune*, February 1, 2010, 15.

(123) The five largest U.S. banks, which dominate the derivatives business paid lobbyists to argue that excluding banks from derivative markets would make the markets less safe by shifting the trading to foreign banks and other institutions that are subject to less US government oversight. The financial industry also says that derivatives are valuable products used by 95% of Fortune 1000 companies to hedge against risks such as price changes. Binyamin Appelbaum and Eric Lichtblau, "U.S. Banks Focus Fighting on Derivatives Trading Ban," *International Herald Tribune*, May 11, 2010, 3.

(124) Section 619(c).

(125) Section 619(b).

(126) Section 619(a)(2).

(127) Section 619(d).

of customers; (5) risk mitigating hedging activities designed to reduce specific risks to the banking entity; (6) investments in small business investment companies; (7) insurance company general account investment activities; (8) organizing a hedge fund or private equity fund if the bank provides bona fide trust services or investment advisory services; and (9) activities conducted by a foreign company solely outside the United States as long as the company is not directly or indirectly controlled by a US company. In addition, an exception is provided for *de minimis* investment activities of up to 3% of the Tier 1 capital of the particular banking entity.[128] The Federal banking agencies, the SEC, and the CFTC must issue regulations and impose additional capital requirements and quantitative limitations on such activities.[129] Banking entities enjoy a grace period of two years to comply with the Volcker rule that may be extended further up to five years.[130] Section 620 of the Act requires a study of bank investment activities and the Volcker rule.

(2) Senator Blanche Lincoln (D. Ark) "push out" rule. Senator Lincoln wanted the Act to compel depository institutions to spin off their derivative and swaps trading to affiliates. As a compromise, section 716 of the Act provides that within two years, banks must spin off certain swap activities: CDS, equity and commodity swap-trading. Banks may continue foreign exchange, gold, silver, and interest-rate swap-trading. The intent of this provision is to "push out" – delink – what are considered the more risky swaps from the various forms of federal support commercial banks enjoy (the federal safety net).

(3) Concentration limits. Additional banking reforms in the Act include upgraded standards for interstate acquisitions and mergers; financial holding

(128) Section 619(d)(4). Tier 1 capital is defined in the Basel I Accord of 1988 as including the company's value of total common stock plus retained earnings or reserves. Tier 1 capital is the core measurement of a bank's financial condition from a regulatory standpoint.

(129) Section 619(d)(2)-(3).

(130) Section 619(c).

companies must obtain advance approval from the Federal Reserve before acquiring a non-bank company with assets in excess of $10 billion.[131] New concentration limits are adopted for large financial companies[132] because of concern over excessive monopoly and oligopoly power among financial companies that was exacerbated by consolidations that occurred during the Financial Crisis. The Financial Stability Council must make a study and report on concentration limits in the US financial industry.[133]

(4) Electronic debit transactions. The Act requires the Federal Reserve to issue regulations to require banks to impose reasonable interchange transaction fees, defined as "proportional to the cost incurred by the issuer [of the card] with respect to the transaction."[134]

(5) Improving access to mainstream financial institutions. Title XII of the Act authorizes the Secretary of the Treasury to establish a multiyear program to enable low- and moderate income persons to establish accounts in mainstream depository institutions.[135] The Secretary is also directed to establish demonstration programs to provide low-cost small loans to consumers as alternatives to more costly "payday" loans.[136]

6. The Bureau of Consumer Financial Protection

Section 1011 of the Act establishes a new Bureau of Consumer Financial Protection (hereinafter the Bureau) within the Federal Reserve System that will operate autonomously to develop rules designed to educate consumers of financial products and to protect their interests. The new Bureau, which will

---

(131) Section 623.
(132) Section 622.
(133) Section 622(e).
(134) Section 1075.
(135) Section 1204.
(136) Section 1205.

be headed by a Director and a Deputy Director, will consolidate functions now housed in other federal financial agencies as well as establish new protections for consumers. The Bureau will have functional units for research, community affairs, collecting and tracking consumer complaints (a "hot line").[137] An Office of Fair Lending and Equal Opportunity will be established within the Bureau.[138] An Office of Financial Literacy within the Bureau[139] will provide education and financial counseling services. The Bureau will be assisted by a Consumer Advisory Board consisting of at least 6 members appointed by the Director.[140]

The Bureau will assure that consumers are provided with timely and understandable information about financial products, and are protected from unfair practices and deceptive acts. The Bureau will promote transparency and assure the enforcement of federal consumer financial laws.[141] The Bureau may develop rules to protect consumers and may require reports and conduct examinations of financial institutions in order to detect and assess risks to consumers and to markets for consumer financial products.[142] The Bureau may prescribe rules for disclosure to consumers[143]; for prohibiting or restricting mandatory pre-dispute arbitration between consumers and financial companies[144]; and to prohibit unfair, deceptive, or abusive acts or practices.[145] The Bureau may commence civil actions to enforce consumer financial laws[146] and may make referrals to the US Department of Justice for possible criminal action.[147] Retaliatory actions against "whistleblowers" are prohibited.[148] State

(137) Section 1013(b).
(138) Section 1013(c).
(139) Section 1013(d).
(140) Section 1014.
(141) Section 1021.
(142) Sections 1025-26.
(143) Section 1032 and 1033.
(144) Section 1028.
(145) Section 1031.
(146) Section 1054.
(147) Section 1056.
(148) Section 1057.

law is specifically preserved, although inconsistent state law may be preempted by federal law or regulations.[149] But state consumer laws will be preempted only to the extent they prevent or significantly interfere with the exercise by a national bank of its powers.[150]

7. Regulation of Derivatives, Swaps and Securitizations

(1) Regulation and reporting of derivatives and swaps markets. The heart of the new Act extends government regulation over the markets for derivatives and swaps for the first time. The Act implements the agreement by the G-20 that all standardized over-the-counter derivative contracts should be traded on exchanges or electronic trading platforms and cleared through central counterparties, and that privately negotiated derivative contracts should be reported to trade repositories and counterparties to such contracts should be subject to higher capital requirements.[151] Virtually all derivatives and swaps transactions must be reported and will be publicly available in real time.[152] The Act thus repeals the exemption for derivatives and swaps contained in the Commodity Futures Modernization Act of 2000. Regulation of derivatives is delegated to the SEC under the Act; regulation of swaps is shared by the SEC and the CFTC: The SEC has jurisdiction over security-based swaps – those in which a material term of the agreement is based on the price, yield, value, or volatility of any security or group or index of securities – which would include credit default swaps.[153] The CFTC has jurisdiction over other swaps such as agricultural swaps and interest-rate swaps. The Act prohibits swaps based on agricultural commodities except those expressly permitted by the CFTC.[154] Moreover, the CFTC has wide powers to prevent trading of futures contracts that

(149) Section 1041.
(150) Section 1044.
(151) Section 702(a)(12).
(152) Section 727.
(153) Section 712.
(154) Section 723(c)(3).

are deemed not in the public interest.[155] Examples of such contracts would be a futures contract on some event, such as the Superbowl or a terrorist attack. Such events contracts would be forbidden because their purpose is gaming rather than hedging.

(2) Market participant registration. Market participants in the derivatives and swaps markets must register with the appropriate agency,[156] and the SEC and the CFTC have rulemaking authority and may also issue rules jointly. No federal government assistance may be paid to swaps entities.[157] Abusive swaps may be prohibited,[158] and the SEC and CFTC have authority to prohibit participation in swaps activities.[159]

(3) International coordination. The SEC, CFTC, the US Department of the Treasury and the Financial Stability Oversight Council must consult and coordinate the regulation of derivatives and swaps with foreign regulatory authorities in order to promote effective and consistent global regulation of these markets.[160]

(4) Securitization: the "skin in the game rule." Subtitle D of Title IX of the Act sets out mandatory standards for securitization transactions. Chief among the reforms is a risk retention requirement that the originator of the asset must meet: not less than 5% of the credit risk for mortgage backed securities, and

(155) Section 745.

(156) Section 764 of the Act adds a new section 15F to the Securities Exchange Act of 1934, 15 USC sec. 78a et seq., to require registration of security-based swap dealers and major security-based swap market participants. Section 717 of the Act amends the Commodity Exchange Act, 7 USC sec. 1 et seq., is amended to add new section 4s to require registration and regulation of swap dealers and major swap participants.

(157) Section 716.

(158) Section 714.

(159) Section 715.

(160) Sections 752 and 761.

rules will be promulgated jointly by the SEC and federal banking agencies requiring risk retention percentages for additional classes of asset-backed securities.[161] Asset-backed securitizations will also be subject to additional disclosure requirements concerning the underlying assets upon which their value depends,[162] and the SEC will promulgate rules on warranties and representations in asset-backed securities offerings.[163]

8. Clearing, Payment and Settlement Activities

Title VIII of the Act provides special oversight authority over financial market utilities engaged in securities clearing, payment and settlement activities. The Federal Reserve Board has authority to prescribe standards for systemically important financial market utilities and payment, clearing or settlement activities, taking into account relevant international standards and existing prudential requirements. The Financial Oversight Council by two-thirds vote may designate such a utility as "systemically important,"[165] which will authorize the Federal Reserve and other regulatory agencies to prescribe risk management standards addressing such matters as margin and collateral requirements, participant or counterparty default policies and procedures, the ability to complete timely clearing and settlement of financial transactions, and capital and financial resource requirements.[166] Financial clearing utilities are subject to annual examination and the Federal Reserve in consultation with the Council may recommend that the applicable supervisory agency take enforcement activity against the financial utility.[167]

(161) Section 941.
(162) Section 942.
(163) Section 943.
(164) Section 805-06.
(165) Section 804.
(166) Section 805
(167) Sections 807-08.

9. Reinvigorating the SEC and Investor Protection

On September 14, 2009, in the case of *Securities Exchange Commission v. Bank of America Corporation*, Judge Jed Rakoff angrily rejected the SECs proposed $33 million settlement of the agency's securities fraud case against the bank, with the stinging comment that the SEC proposed settlement "does not meet the most elementary notions of justice and morality."[168] The SEC has widely been blamed for neglecting its role to protect investors, to maintain orderly financial markets, and to facilitate capital formation and has rightly received a share of the blame for the financial Crisis.[169]

Since 2009, with the appointment of Mary L. Schapiro as Chairperson of the five-member SEC, the agency has been in the throes of a reorganization that will be enhanced by the passage of the Wall Street Reform and Consumer Protection Act of 2010. Schapiro appointed new leadership to run the SEC's four largest operating units, the Division of Enforcement, the Office of Compliance, Inspections and Examinations, the Division of Trading and Markets, and the Division of Corporate Finance. The SEC also created a new Division of Risk, Strategy, and Financial Innovation to focus attention on new products, trading practices and risks. The SEC has attempted to reinvigorate enforcement by creating five new investigative groups: Asset Management (hedge funds and investment advisers); Market Abuse (insider trading and market manipulation); Structured and New Products (derivatives), Foreign Corrupt Practice Act violations; and Municipal Securities and Public Pensions. The Enforcement Division has also created a new Office of Market Intelligence to handle complaints and tips and referrals. SEC enforcement actions have roughly

(168) *Securities Exchange Commission v. Bank of America Corp*, 09 CIv. 6829 (JSR), Memorandum Order, September 14, 2009.

(169) Theo Francis, "SEC's Cox Catches Blame for the Financial Crisis", *Bloomberg Business Week*, September 19, 2008, available at www.bloombergbusinessweek.com/bwdaily, visited July 27, 2010.

doubled in the past year.[170] In the first seven months of 2010 the SEC has settled three separate securities fraud cases against large financial companies: the case against Bank of America was ultimately settled for a $150 million fine; a case against Goldman Sachs was settled for $550 million; and a case against Citibank was settled for $75 million.[171]

The Dodd-Frank Wall Street Reform and Consumer Protection Act requires the SEC to promulgate a large number of new rules, create five new offices, and conduct multiple studies,[172] many within one year. The Act strengthens the SEC's mandate to protect investors by creating a new Investor Advisory Committee to consult with the Commission on regulatory priorities, issues relating to securities products, initiatives to protect investors, and initiatives to promote investor confidence in the securities markets.[173] A new Investor Advocate Office and Ombudsman will also look out for the interests of retail investors. Subtitle F of Title IX requires improvements to management of the SEC, upgrading internal supervisory control of the agency and requiring the Comptroller General to report on the SEC's personnel policies and the SEC's oversight of national securities associations, such as the Financial Industry Regulatory Authority (FINRA).[174] Not less than 90 days after the passage of the Act, the SEC must retain an independent consultant to examine, evaluate and report to Congress on its internal operations. The SEC must then report to Congress on its implementation of the independent consultant's report.

---

(170) Mary L. Schapiro, *Testimony Concerning Oversight of the U.S. Securities Exchange Commission: Evaluating Present Reforms and Future Challenges, Before the United States House of Representatives Committee on Financial Services*, July 20, 2010, available at www.sec.gov/new/testimony, visited July 23, 2010.

(171) Zachary A. Goldfarb, "Citigroup Agrees to SEC Settlement," *The Washington Post*, July 30, 2010, A12.

(172) For example, a study on mutual fund advertising (section 918); a study on investor financial literacy (section 917); a study on conflicts of interest (section 919A); a study on improved investor access to information on investment advisors and broker-dealers (section 919B); and a study on financial planners (section 919C).

(173) Section 911. Members will be appointed to serve four year terms.

(174) Section 964.

The SEC has major new responsibilities in a number of areas:

- **Hedge funds and investment advisers.** Title IV of the Act (Private Fund Investment Advisors Registration Act) extends SEC authority over advisers of hedge funds and private equity funds, who must also meet new recordkeeping and disclosure requirements. The asset threshold for SEC regulation of investment advisers is raised to $100 million so that state authorities' jurisdiction over investment advisers is increased. This will allow the SEC to focus its regulatory energy on advisers of large entities. The Act greatly increases the number of investment advisers who must register by eliminating the private adviser exemption, which formerly exempted advisers with fewer than 15 clients and who did not advise a registered investment company or business development company. Formerly exempt advisers must now register unless they qualify for one of the more narrow new exemptions created by the Act: exemptions for (1) mid-sized private fund advisers with less than $150 million of assets under management in the United States; (2) venture capital advisers; (3) foreign private advisors with no place of business in the US, fewer than 15 US clients, and with less than $25 million (or such higher amount as the SEC may determine by rulemaking) under management attributable to US clients; (4) family offices; (5) commodity trading advisers; and (6) small business investment companies.
- **Municipal advisers.** Subtitle H of Title IX creates a new category of persons – municipal advisers – who must register with the SEC. A municipal advisor is a person who "provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities … or undertakes the solicitation of a municipal entity."(175) Such municipal advisers shall owe a fiduciary duty to any municipal entity for whom it acts as advisor. The Act establishes a new Office of Municipal Securities within the SEC.(176) A 15 member Municipal

(175) Section 975(e).
(176) Section 979.

Securities Rulemaking Board will have responsibility to formulate and enforce rules for municipal advisers.(177)

- **Credit rating agencies.**(178) A new Office of Credit Ratings is created within the SEC to examine credit rating agencies (nationally recognized statistical ratings organizations) at least once a year. Credit ratings agencies must disclose their methodologies, their use of third parties and their ratings track record. New standards of liability apply to credit ratings agencies: an inference of liability will arise if the credit rating agency failed to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating the credit risk, or failed to obtain reasonable verification of such factual elements from sources independent of the issuer and underwriter that the credit agency considered to be competent. Statements by credit ratings agencies will not be deemed forward-looking statements eligible for the safe harbor of section 21E of the Securities Exchange Act. The SEC has the power to deregister a credit ratings agency for providing consistently bad ratings.
- **Executive compensation and corporate governance.** The Act requires each company subject to the SEC's compensation disclosure rules to include a non-binding "say on pay" vote in its proxy statement at least once every three years so that shareholders have the opportunity to approve the compensation of named executive officers as disclosed in the proxy statement. In a separate non-binding vote held at least every six years the shareholders may determine whether say on pay voting is to occur every one, two, or three years. If a company seeks shareholder approval for a merger sale of assets of the company, the company must disclose in its proxy materials any "golden parachute" compensation and give the shareholders the opportunity to approve by a non-binding vote. In addition, federal financial regulators have authority to issue and enforce joint rules on

(177) Section 975(b).

(178) Subtitle C of Title IX, sections 931-939H.

executive compensation specifically applicable to financial institutions. The SEC is empowered to adopt rules to assure the independence of company compensation committees and their advisors. The Act gives the SEC authority to issue rules that allow shareholders to nominate directors by using the company's proxy solicitation materials. Violation of "say on pay" rules may lead to "clawback" of the compensation in question.

The Act also provides the SEC with numerous instances of enhanced regulatory and enforcement authority. The highlights are as follows:

- **Fiduciary duty standards for brokers, dealers and investment advisers.** Within six months the SEC must complete a report to Congress concerning the effectiveness of existing legal standards of care for brokers, dealers and investment advisers with respect to their advice to retail investors.(179) The SEC is authorized, at its discretion, to promulgate rules to address the standards of care and to establish a fiduciary duty standard for brokers and dealers who provide personalized investment advice to retail customers. The SEC may by rule provide that the same standard of care, fiduciary duty, applies for investment advisers and broker-dealers who deal with retail customers.(180) The SEC shall promulgate rules to facilitate the clear disclosure of information to investors, including conflicts of interest, and may, where appropriate, prohibit certain practices, conflicts of interest, and compensation schemes.(181)
- **Mutual fund advertising.** The SEC must examine and may promulgate new regulations to govern mutual fund advertising.(182)
- **Financial planners.** The SEC must conduct a study of the role of financial planners and the use of financial planner designations.(183)

---

(179) Section 913 (a)-(e).
(180) Section 913 (k) and (g).
(181) Section 913 (l).
(182) Section 918.
(183) Section 919C.

- **Enforcement and remedies.** The SEC may by rule prohibit or place conditions on the use of agreements that require customers or clients of broker-dealers or investment advisors to arbitrate future disputes.(184)
- **Whistleblowers.** The SEC is required to pay whistleblowers who provide original information that leads to successful enforcement a portion of the total amount collected. Employers are prohibited from firing whistleblowers.(185)
- **Short sales.** The SEC must promulgate rules on disclosure of short sales of equity securities.(186)
- **Accredited investor standard.** For purposes of Regulation D of the Securities Act of 1933 the accredited investor net worth threshold of $1 million cannot include the investor's primary residence.(187)
- **Aiding and abetting securities fraud.** The Act expands the liability of aiders and abettors.(188) The SEC is authorized to bring enforcement actions against aiders and abettors; and the standard of *scienter* (knowledge) for aiders and abettors is *reckless* as well as knowing conduct that provides substantial assistance to primary violators.(189) The Comptroller General must conduct a study on the impact of allowing aiding and abetting claims in private securities actions, examining, among other matters, the case of *Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc*., 552 U.S. 148 (2008), a case in which the Supreme Court ruled (three justices dissenting) that investors cannot bring a private securities fraud action against third-party aiders and abettors because they did not rely upon their statements when they purchased their securities.
- **Nationwide service of subpoenas.** The securities acts are amended to

(184) Section 921.
(185) Sections 922-24.
(186) Section 929X.
(187) Section 413(a).
(188) Section 929N.
(189) Section 929O.

permit nationwide service of SEC subpoenas in civil actions filed in federal court.(190)

- **Extraterritorial private rights of action.** The SEC must conduct a study of whether private actions under the antifraud provisions of the Securities Exchange Act should cover conduct occurring outside the United States.(191) The Supreme Court of the United States, in *Morrison v. National Australia Bank, Ltd.*,(192) ruled that the securities antifraud rules apply only to transactions involving securities that are traded on U.S. exchanges or where ownership of securities changes hands in the United States. The Act, which was passed after the decision in the *Morrison* case, allows the SEC to apply the fraud rules extraterritorially, but not private investors.
- **Accounting.** The Act gives the Public Company Accounting Oversight Board the power to share documents and information with foreign auditor oversight authorities at its discretion.(193) The Board is also authorized to inspect registered public accounting firms that audit brokers and dealers.(194)

10. Mortgage Reforms

The mortgage reform provisions of the Act respond to the subprime loan Crisis that triggered the Financial Crisis. Federal standards are established for residential mortgage loans so that financial institutions cannot make loans unless there is reasonable certainty that the loans will be repaid. More disclosures for consumer mortgages are required and special safeguards apply to high-cost mortgages. Penalties are established for predatory or negligent lending activities.

Title XIV of the Act, entitled the Mortgage Reform and Anti-Predatory Lending Act, responds to the subprime lending aspect of the Global Financial Crisis by enacting significant mortgage reform provisions. Originators of

(190) Section 929E.
(191) Section 929Y.
(192) ___ S. Ct. ___(2010).
(193) Section 981.
(194) Section 982.

residential mortgages may not receive “yield spread premiums,” compensation that varies with the terms of the mortgage loan (other than the principal amount).[195] The Federal Reserve is mandated to publish minimum standards for mortgages so that lenders may not make residential mortgage loans unless they reasonably and in good faith determines based on verified information that the customer has reasonable ability to repay the loan.[196] Violations of the mortgage origination and repayment violations may be used as a defense in foreclosure proceedings.[197] Required disclosures under the Truth in Lending Act are increased[198]; and property appraisal standards tightened to assure appraisal independence, competence and accuracy.[199] A new Office of Housing Counseling is established in the US Department of Housing and Urban Development.[200]

VI. CONCLUSIONS

At this writing, three and a half years after the onset of the worst economic crisis of the past 75 years, the world, despite a few bright spots in Asia and Latin America, is still mired in economic doldrums. Economic recovery is still very fragile with high unemployment and the most difficult labor market since the 1930s. The world is probably less than halfway through this period of economic malaise, and much more work needs to be done if we are to avoid a long period of economic stagnation. We have only begun to address the underlying causes of the Global Financial Crisis.

One consolation: it could have been worse. The Crisis revealed flaws in global economic institutions, and the G-20 became the driver of global cooperation and coordination of monetary and fiscal policy as well as efforts

(195) Sections 1402-05.
(196) Section 1411-12.
(197) Section 1413.
(198) Sections 1432-33.
(199) Sections 1471-75.
(200) Sections 1442-44.

to correct regulatory failings and to strengthen global economic institutions. However, will that cooperation and coordination continue? To work our way out of the Crisis, international cooperation must continue and even increase. Coordinative monetary and fiscal policies must continue in order to avoid new rounds of deflation or inflation; a new Basel III regime for capital and liquidity standards for financial companies must be agreed and implemented; global current account imbalances need to be addressed in a cooperative manner; harmonized standards for the regulation of swaps and derivatives and other aspects of the international financial markets must be agreed; and nations must cooperatively address the sovereign debt problem to reduce debt at a measured pace, but not so severely as to sacrifice the fragile economic recovery now underway. Continued international efforts have only begun, and, while these merit much praise, the future remains uncertain.

The United States, where the Global Financial Crisis began, has addressed the Crisis, first, by deploying unprecedented monetary and fiscal policy tools, and then, in July 2010, by enacting historic financial reform legislation. U.S. monetary policy was handled deftly by the Federal Reserve; the agency under Chairman Ben Bernanke pulled out all the stops, using monetary tools that have not been deployed for 75 years. U.S. fiscal policy has been less successful; the TARP saved the U.S. commercial banking system and General Motors, but has failed to revive credit markets or to benefit ordinary Americans who have lost their jobs and whose homes are in foreclosure. The economic stimulus enacted by Congress, whose largest item was for highway construction projects, was unfocused and too little, too late. It has not made a significant dent in the high U.S. unemployment rate.

U.S. regulatory reform, the Dodd-Frank Wall Street Reform and Consumer Protection Act, is a brave attempt to address the basic causes of the Crisis: the subprime loan problem; lax regulation of financial companies, including commercial banks, investment banks, hedge funds, and insurance companies; the unregulated swaps and derivatives markets; the failings of the credit ratings agencies; and the failings of American regulatory agencies such as the Securities

Exchange Commission. The Act also addresses systemic risk for the first time and seeks to preclude future government bailouts by creating a Financial Stability Oversight Council to oversee the entire financial system, to provide early warning of possible systemic problems and to create a process for orderly liquidation of even the largest financial institutions if they become insolvent. However, the Act exacts a high price in return for addressing these issues: there will be exponential growth in government oversight of financial markets, and U.S. financial regulatory institutions will double or triple in size. Far from creating a nimble and effective regulatory regime, the Act appears to create an unwieldy bureaucracy. In any case, much will depend on the implementation of the mandated reforms; the Act does very little that will have immediate impact. The reform process will take many years for the regulatory agencies to complete.[201] Management of the reform process mandated by the Act will be the crucial test of its effectiveness.

(201) For example, the full effect of the Volcker rule can be deferred until 2017; and the reforms required by the Basel Committee on Banking Supervision (Basel III) may extend to 2018. As Roy Smith, Professor of Finance at New York University and a former Goldman Sachs executive, puts it, "Based on our experience of government's ability to execute these things effectively and in a timely way, we are almost uncovered now from any future financial risk for at least another 8 to 10 years, and that's a little scary." Christine Harper, "2015 Crash Won't Wait for Regulators," *The Japan Times*, August 16, 2010, 11.

Saving the Global Financial System: International Financial Reforms and United States Financial Reform, Will They Do the Job?

<Summary>

Thomas J. Schoenbaum

What is now called the Global Financial Crisis may be analyzed as a cascading series of seven distinct crises, the effects of which are with us still: (1) the subprime mortgage crisis; (2) investment banking crisis; (3) the commercial banking crisis; (4) the stock and commodities markets crisis; (5) the Great Recession; (6) global economic contraction; and (7) the sovereign debt crisis. The series of economic events of the past three years are unprecedented: the world is still dealing with the worst economic downturn in 75 years. No one cause is responsible for the Global Economic Crisis; rather, at least twelve causes acting synergistically can be identified. Unlike most past economic train-wrecks the Crisis had its epicenter in the United States. The Crisis called forth unprecedented international efforts to deal with its causes and to mitigate its effects. International cooperation and coordination, despite some minor problems, has been and continues to be remarkable, and is the most important reason why the world has not been plunged into more serious economic decline. The G-20 in particular has become the single most important international economic body and has dealt with the Crisis effectively. At the G-20's insistence reforms have been made to global economic institutions such as the International Monetary Fund and the World Bank. In the United States monetary policy has been more successful than fiscal policy in dealing with the Crisis. The United

States also has enacted an historic financial reform law, the Dodd-Frank Wall Street Reform and Consumer Protection Act, which attempts to deal with the principal causes of the Crisis in the U.S. economy. Dodd-Frank is a valiant effort to deal point-by-point with the principal causes of the Crisis. This Act makes revolutionary changes: an exponential increase in governmental regulation of the U.S. financial industry by a vast new bureaucracy of regulators. However, the process of reform initiated by the Act will take many years to accomplish and will depend on wise implementation to be successful.